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**CHINA LIGHTS**

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**EXCISE**

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**I. CHINA/US: THROUGH A GLASS DARKLY (9/8)**

Beijing's hard-liners see recent developments in US policy toward China in a dark light: aggressive administration enforcement of trade legislation, along with recent statements about Taiwan, imply a concerted effort to subvert Chinese communism. But the leaders still hope a low-key approach of measured compromises and open-ended talks on trade, human rights, and arms proliferation will stabilize relations.

Bilateral developments in recent weeks, and the US reaction to Soviet events, have raised the suspicion and ire of China's hardline leaders. Their list includes: a new US willingness to attack Chinese interests directly, as shown by the recent Customs raids on Chinese textile firms; perceived US pressure, by means of deadlines on market access and intellectual property protection, for deep changes in China's economy; the new US commitment to Taiwan's early GATT entry, and new ideas about Taiwan's status enunciated by former US officials--viewed as US efforts to "play the Taiwan card"; and interference in China's internal politics--the Pelosi "demonstration" on Tiananmen square.

**Visions of conspiracy.** Hard-liners were already predisposed to see US actions as part of a systematic offensive against China. Some, for example, saw Washington's delayed response to China's flood disaster as betraying a US hope that the disaster would cause social unrest and destabilization. Hard-liners see the collapse of Soviet communism as a product of western, especially US, pressure and believe the United States intends now to bring down communism in China. At least some would be willing to let US-China ties deteriorate to secure their political futures.

Moderates on the defensive The Pelosi incident backfired on foreign ministry moderates who had won the argument on issuing visas. Hard-line reaction to US demands at the August trade talks may have stymied efforts [REDACTED] to improve US market access in China, and possibly played into the subterranean prime ministership sweepstakes [REDACTED]

But where to go? Few in Beijing now would go out on a limb to push for the deep systemic changes necessary to satisfy US demands on market access and intellectual property protection. With their position shaky, Beijing's moderates will keep a low profile and wait for the dust to settle from both the Soviet collapse and the heightened tensions in US-China relations.

But the hard-liners, however angry they may be, have few viable options. China's sometimes touted affinity for the third world, never a useful policy prescription, is irrelevant given changes in the international order, and allying with foreign communist remnants offers China no hope for circumventing, much less countering US diplomacy.

China's leaders will continue to view US actions through a dark lens, and hard-liners will oppose concessions to the United States but moderate forces favoring good US ties still have some leverage. And the top leadership's recent warm, though anxious, reception of the Kissinger delegation shows a reservoir of hope that attests to the importance it attaches to bilateral ties. (JHuskey) (CONFIDENTIAL)

## II. CHINA: KEEPING THE FAITH (9/10)

Beijing's response to developments in Moscow since the coup attempt has been to reiterate its intention to pursue its own path and stick to socialism. But Soviet events have heightened tension between those who argue that only further reform can avoid domestic chaos and regime-threatening challenges, and those who insist that only further repression and stepped-up propaganda can forestall such dangers. This conflict appears to have marginally strengthened Deng Xiaoping, who once again seems to be asserting his role as bridge between the two camps.

Premier Li Peng recently reiterated China's official response to the coup: "No matter how the Soviet Union changes, and no matter how the international situation changes, China will firmly adhere to the course of building socialism with Chinese characteristics and will uphold the reform and opening policies" of Deng. But after more than a decade leaders remain

at loggerheads over the content of such slogans [REDACTED] t

Political vigilance. Since the coup attempts Chinese media have stepped up calls for political education and control; a recent People's Daily article warned that the "hostile forces" at home and abroad that instigated the Tiananmen crisis were waiting to unleash another attack. To counter liberalized thinking, the leadership is alleged to have set up a high-level "peaceful evolution" committee. Beijing also has moved to ensure the loyalty of military and security forces; an all-army propaganda meeting in early September called for stepped-up indoctrination and heightened ideological awareness. But the forum was held in Guangzhou, capital of China's most open province, where participants could see the benefit--as well as the dangers--of China's outward-oriented policy.

Accelerating reform. A September 2 People's Daily editorial, an authoritative outlet for leadership views, called for balance between strengthening party rule and accelerating reform and opening. The editorial reiterated key canons of Deng's thinking, including the centrality of economic growth, the importance of science and technology, and the need for further opening to the outside. The editorial may have been intended in part of reassure key domestic and foreign constituencies that China will not roll back reforms because of Soviet "setbacks." But economic problems and the need to maintain popular support may force the leadership to do more than pay lip service to speeding up reforms.

Deng back in the center? The editorial may have been something of a victory for Deng, who earlier this year seemed unable to get his views published in national media. [REDACTED] b

[REDACTED] Deng's hand may also be visible in the composition of the preparatory group for next year's party congress--at least six of the 11 members lean toward Deng, only one true hard-liner is included, and Li Peng is not a member. [REDACTED] b

(CClarke) (CONFIDENTIAL)

### III. CHINA: STATE ENTERPRISES IN CHAINS (9/9)

The central problem facing China's economy--low efficiency in state enterprises--continues to worsen, despite growing industrial production and better wholesale and retail sales.

Hard-line policies of propping up chronically money-losing state firms with bank loans and state subsidies threaten renewed inflation. If hardliners reimpose economic austerity, state firms would be squeezed hard. The worsening plight of state firms, and state budget deficits may force China's leaders to accelerate price adjustments and welfare and bankruptcy reform.

State planning chief and Vice Premier Zou Jiahua on September 2 gave a relatively upbeat assessment of China's mid-year economic performance to the National People's Congress standing committee. GNP grew 6.1% over the same period last year, and industrial production jumped 13.5%. State industrial sales increased more than 15%, and retail sales rose more than 9%, significant improvements over the sluggish pattern since 1989.

State firms shackled with debt. Zou acknowledge, however, that state firms continue to lose large amount of money. Despite efforts to break the "chain of debt" that has plagued the state sector since Beijing temporarily cut back on credit in late 1988, state-enterprise debt has grown sharply. According to a Chinese study, bank loans in 1990 accounted for 80% of the working capital in 7,000 state firms surveyed, up from 58% in 1984. Loans to these enterprises in 1990 increased 31%, adding another five billion yuan in interest payments by already strapped firms, while output rose only 3.1%. Subsidies of 160 billion yuan were given to keep debt payments current, but 1990 arrears were up 150 billion yuan by year end and have continued to climb since.

Since being brought to Beijing earlier this year, Vice Premier Zhu Rongji has been put in charge of making the state sector more efficient. But he has done little but extend new loans, step up experiments with industrial trusts, and jaw-bone. Measures to address the root causes of inefficiency--irrational prices, inflexible management and labor systems, and "soft" budget constraints--have yet to be adopted.

Political implications. Under pressure from industry and provincial leaders, Beijing in 1990 reopened the credit spigot it had shut during the austerity program of 1988-89. The resultant increase in credit allowed state firms to plunge deeper into debt, without any regard to their basic inefficiency. Increase in the money supply now threatens a new bout of inflation. If hardliners clamp down again, debt-ridden state enterprises will be even less able to weather the crisis; another recession would probably mean worker idleness, short paychecks, and the possibility of localized work disturbances. Hard-liners will not be able to escape blame: their claim to leadership is predicated on maintaining economic and social stability.

The worsening condition of the state sector--and the need to bolster regime legitimacy through economic performance after the failed Soviet coup--may give new impetus to reform. A September 2 editorial in People's Daily--an authoritative outlet for leadership views--called for further economic reform and opening to the outside, an emphasis Deng Xiaoping has been trying unsuccessfully to revive since spring. Major policy changes are unlikely, but another serious round of stagflation could encourage renewed experiments with bankruptcy regulations, greater urgency in setting up unemployment insurance and other safety-net programs, accelerated banking reforms, and price adjustments that would reduce subsidies and prepare the way for further marketization. (CClarke) (CONFIDENTIAL)

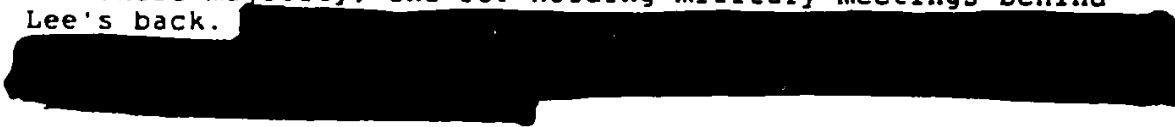
IV. TAIWAN: POLITICAL MANEUVERING (9/8)

Rivalry between the Taiwanese mainstream and mainlander old-guard factions of the ruling Kuomintang (KMT) and between the moderate and pro-independence wings of the opposition Democratic Progressive party (DDP), is intensifying in the run-up to December 21 national assembly elections. But factional leaders in both parties are acting with restraint to preserve party unity and strength, and tacit collaboration between moderates of both parties will probably continue to hold in check conflicts over the incendiary independence issue.

Despite increasing KMT polarization between mainstream Taiwanese supporters of President Lee Teng-hui and conservative anti-independence mainlanders who now look to Premier Hau for leadership, the factions have continued to work together in the interest of party unity. The balance of power within the party will tilt decisively in favor of the Taiwanese after the forced retirement of mainland-elected legislative yuan and national assembly members at year's end. However, conservative mainlanders will still play an important role in the party organs and continue to buffer PRC criticism that Lee and his Taiwanese mainstream faction are closet independence supporters.

Lee-Hau face off. The highly publicized Lee-Hau conflict of recent months reflects KMT factional division, rivalry between Taiwanese and mainlanders, and the unclear, unwieldy constitutional division of powers between the president and the premier. Mainstream Taiwanese have attacked Hau for alleged disrespect to the president, insensitive statements about the Taiwanese majority, and for holding military meetings behind Lee's back.

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Hau has nonetheless subordinated himself to Lee and has probably stayed on to ensure a strong voice within the government for anti-independence conservatives. For Lee, sticking with Hau keeps conservatives on board, ensuring continued KMT domination. Lee and Hau have publicly patched up their differences whenever perceptions of personal and factional rivalry have threatened to undercut KMT unity or Taiwan's international image.

DPP in the wilderness. In the organizationally weaker DPP, the pro-independence New Movement faction has long been able to steer the party into controversial and confrontational positions. An example is the New Movement's recent draft "Republic of Taiwan" constitution. The surreptitious return of overseas independence activists, coupled with the radicalization of some DPP dissidents, makes for a volatile pro-independence atmosphere.

But past patterns of conflict between pro-independence radicals and KMT conservatives, followed by a cooling-off brokered by moderates of the two parties, seem likely to be repeated. Politically burned in the past by strong public reaction to their heavy-handed tactics, KMT conservatives increasingly prefer to let the courts deal with DPP radicals and wayward sons returning to advocate Taiwan independence.

Moderate DPP party leaders and legislators have shown an aptitude for compromise with the KMT mainstream--recently, for example, cutting a deal on election law changes. With both parties divided, compromise between KMT and DPP moderates will be essential if constitutional amendments are to be approved next year by the new national assembly.

The KMT has begun to plan new constitutional reforms, but so far has decided only on one issue--supporting indirect presidential election through the national assembly. The DPP strongly favors direct presidential election and is certain to attack the KMT position as undemocratic. Other controversial issues include redefinition of presidential powers and relations between the premier and the legislative yuan.  
(MFinegan) (SECRET/NOFORN/NOCONTRACT/ORCON)

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V. HONG KONG/UK/PRC: DEMOCRATIC BEGINNINGS (9/17)

Hong Kong took a significant step toward representative democracy on September 15 when first-ever direct elections were held for 18 of 60 legislative council (Legco) seats. The liberal United Democrats of Hong Kong (UDHK) and their allies did better than projected, winning 16 seats. Beijing-supported candidates lost all contests, as did the conservative,

business-oriented Liberal Democratic Federation, which favors close cooperation with the PRC. Voter turnout was 39%, well below the 50% the government hoped for but still higher than any previous Hong Kong election.

Political parties began forming in Hong Kong only last year. The best organized and most popular—the UDHK—is also on the worst terms with Beijing; the UDHK evolved from the Hong Kong organization that was most active in supporting the democracy movement in China. Before the election the colony's Beijing-controlled press denounced the platform of the UDHK, and its very relations with China as a threat to Hong Kong's stability.

By focusing the election on whether candidates were pro-China or pro-democracy, Beijing's "meddling" played into the hands of the liberals. Beijing has made a point of shunning the UDHK leader, attorney Martin Lee, an outspoken advocate of democracy. Lee refuses to be ignored, and immediately after the election called for dialogue with PRC representatives in Hong Kong.

The new political lineup. Lee is also using the election results to press for changes that would give liberals in government a voice in Hong Kong affairs. Traditionally the governor has appointed conservative business and professional representatives to the policy-making executive council (Exco) and the Legco, which has usually rubber-stamped government decisions. In 1985 functional constituencies (bankers, teachers, etc.) first held indirect elections to Legco.

In the contest for 21 functional constituency seats on September 13, conservatives predominated. A further 17 Legco members will be appointed by the Hong Kong governor. (The remaining 4 members serve ex officio.) Though Lee will ask Governor Wilson to appoint liberals to both the Exco and Legco, the governor is unlikely to comply. Even so, Legco will have an unprecedented 19 or 20 liberals; the government will have to take account of their views.

Accelerating democratization. UK Prime Minister Major was clearly encouraged during his recent visit to Beijing by what he described as a new spirit of cooperation on Hong Kong issues and by the fact that China did not raise objections to Hong Kong's recent bill of rights. Major indicated that if the Legco elections produced a strong mandate for democracy, he would ask the Chinese to accept an increase in the number of directly elected legislators. Though Hong Kong liberals will now press for increased representative democracy, Chinese leaders will stiffen their resistance to a system that would make Hong Kong more difficult for them to control.

The election outcome will reinforce PRC leaders' dissatisfaction with the performance of their representatives in Hong Kong, which could lead to personnel shakeups and to demands to step up political work. The next Legco elections, in 1995, are more important to Beijing than the ones this year, because under the "through-train" principle, members elected then will remain in office after the colony becomes a PRC special autonomous region. (MFinegan) (CONFIDENTIAL)